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IN THE

# Supreme Court of the United States

OCTOBER TERM, A.D. 1970

No. 889

BEAR MANUFACTURING COMPANY,
*Petitioner,*

vs.

UNITED STATES OF AMERICA,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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BEAR MANUFACTURING COMPANY,

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioner, Bear Manufacturing Company, prays that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Seventh Circuit entered herein on July 30, 1970.

## OPINIONS BELOW.

The opinion of the Court of Appeals is as yet unreported and appears herein at Appendix A, pp. 1a-5a. Said Court affirmed the judgment of the United States District Court for the Southern District of Illinois entered October 20, 1969. The opinion of the District Court is as yet unreported and appears in Appendix B, infra, pp. 6a-11a.

## JURISDICTION.

The judgment of the Court of Appeals, for which review is sought, was entered July 30, 1970; a petition for rehearing was denied by said Court by order entered August 25, 1970. A copy of the Order denying rehearing is as yet unreported and appears in Appendix C, infra, p. 12a. The proceeding is a civil one. This petition has been filed within 90 days of July 30, 1970. Jurisdiction to review by writ of certiorari the foregoing judgment entered July 30, 1970 is conferred on this Court by 28 U.S.C. §§ 1254 (1) and 2101 (c).

## QUESTIONS PRESENTED.

An accrual method taxpayer, reporting on the calendar year basis, received a tax benefit in each of the calendar years 1939 through 1951 by the practice of accruing as an expense, and deducting from its taxable income, amounts due as royalties from it to its patent licensor. None of these royalties were ever paid. In 1952, the Internal Revenue Service, considering a history of more than ten years inaction by the patent licensor with respect to these accrued but unpaid royalties, determined, during examination of taxpayer's 1949 return, that taxpayer's royalty liability was "too uncertain, contingent and remote to represent a true liability." Accordingly, it then required taxpayer to amend its returns for the three preceding years, 1949, 1950 and 1951, in order that the royalty deductions taken in those years should be restored to income, and that a resulting additional tax could be assessed and paid. This was done and the practice of accruing further royalty liability was discontinued as to subsequent years. Nothing was done or required to be done, however, with respect to the accumulated royalty expense accruals deducted during the years 1939 through 1948, which are conceded to have been legitimate when taken. None of the exclusions of 26 U.S.C. §111 are applicable. In 1962, taxpayer determined that the local statute of limitations, applicable to the patent licensing agreement, had expired and had legally barred all its royalty liabilities by 1959; it thereupon, for 1962, adjusted its books by transferring the amount of these accumulated royalty expenses for the

years 1939 through 1948 from its liability account to its surplus account. The questions presented here relate to taxpayer's federal income tax liability for the calendar year 1962. Those questions are:

(1) Whether under the so-called "tax benefit rule"[1] the previously deducted but unpaid royalty expenses accrued for the years 1939 through 1948 were "recovered" as income by the accrual method taxpayer, and therefore taxable to it (a) by 1949 when the Internal Revenue Service determined that petitioner's liability was "too uncertain, contingent and remote to represent a true liability," or certainly by no later than 1959 when taxpayer's liability for such royalty expenses legally termi-

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[1] At 1 Mertens *Law of Federal Taxation*, §7.34, it is said of the "tax benefit rule" that it originally developed, to a large extent, through court decisions and then found a statutory codification in the 1954 Code at 26 U.S.C. §111 (formerly §22 (b) (12) in the 1939 Code). This case law provided that if an amount deducted from gross income in one taxable year is recovered in a later year, the recovery is income in the later year. *Union Trust Co. of Indianapolis* v. *Comm'r*, 111 F. 2d 60 (7th Cir., 1940) *Cert. den'd* 311 U.S. 658, 61 S. Ct. 12 (1940). The Codes then contained a modification to this rule "that to the extent the deduction in the earlier year did not result in a tax benefit, the recovery is not included in income." Hence the statutes were and are worded "in terms of the amount of the recovery that is *not* included in income." See 1 Mertens, *Law of Federal Taxation*, §7.34. Moreover, while the statutes are by express terms limited to recovery of "bad debts, prior taxes and delinquency amounts," the tax benefit rule has been held not so limited in its application. *Dobson* v. *Comm'r*, 320 U.S. 489, 64 S. Ct. 239 (1943). Income Tax Regulation §1.111-1(a) (70 Vol 1 CCH ¶1127) ..... CFR ..... adopted by T.D. 6220 on 12/28/56 provides that "the rule of exclusion so prescribed by statute [i.e., 26 U.S.C. §111] applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from income for prior taxable years. . . ." Accordingly, no issue is raised as to the applicability of the tax benefit rule.

nated by expiration of local limitations so that the right to restore such items to income became fixed; or (b) whether such items were recovered in the later year 1962 when taxpayer actually restored such items through the adjusting book entry transferring the amount from a liability account to surplus.

(2) If such items of income would under ordinary rules of law be deemed recovered by no later than 1959, does the Commissioner nonetheless have the discretion to add such items of income to the later year 1962 where there exists the "practical consideration" that such items of income might otherwise escape taxation because of the bar of federal limitations under 26 U.S.C. §6501?

## STATUTES AND REGULATIONS INVOLVED.

This case involves various provisions of the Internal Revenue Code of 1954 and the corresponding predecessor provisions of the 1939 Code, the latter being shown in parentheses, as follows: 68A Stat. 33, 26 U.S.C. §111 (formerly 53 Stat. 9, 26 U.S.C. § 22 (b) (12); 68A Stat. 148, 26 U.S.C. § 441 and 68A Stat. 151, 26 U.S.C. § 446 and 68A Stat. 152, 26 U.S.C. § 451 (all formerly 53 Stat. 24 as amended, 26 U.S.C. §§ 41 and 42); and 68A Stat. 803 as amended, 26 U.S.C. § 6501 (formerly, 53 Stat. 86, 87, 26 U.S.C. §§ 275, 276). Income Tax Regulations § 1.111-1 (a), ..... C.F.R. ..... ('70 Vol. 1 CCH ¶ 1127) and § 1.446-1 (c) (i) (ii) ..... C.F.R. ..... ('70 Vol. 1 CCH ¶ 2763) are also involved together with the Illinois statute of limitations on enforcement of written contracts in effect continuously for and during the years

1947 through 1959 at Ill. Rev. Stat. C. 83, § 17. The Illinois General Assembly meets and its statutes are officially published in each off-numbered year (1947) (1949) (1951) (1953) (1955) (1957) (1959). Pertinent parts of these statutes and regulations are set forth in Appendix D, pp. 13a-20a.

## STATEMENT OF THE CASE.

### A. The Patent Royalty Expense Accruals.

The facts are uncontroverted. Petitioner, Bear Manufacturing Company, is an accrual method taxpayer, and reports its income on the calendar year basis. Although organized as a Delaware corporation, its principal office and plant is located at Rock Island, Illinois, where it manufactures and markets automotive safety testing equipment. For the calendar years 1939 through 1951, it accrued as an ordinary business expense and deducted from its taxable income on the returns filed in each of those years certain patent royalties due from it to General Motors Corporation under a written patent licensing agreement made between them in Illinois in 1937. None of these amounts has ever been paid to General Motors. It is agreed that petitioner's taxable income in each of these years was in excess of amounts deducted in such years for an accrued royalty expense.

**B. Respondent's 1952 Determination that Petitioner's Liability for Royalties Had Terminated, as a Practical Matter, by 1949.**

On August 5, 1952, respondent, by its Internal Revenue Service, in an examination of petitioner's return for the calendar year 1949, wrote to petitioner:

> "[The] headlight tester expense deducted in the amount of $20,138.79 is recommended for disallowance. This item represents an accrual of 10% royalty to General Motors Corp. on all headlight testers manufactured during the year 1949. This accrual is contigent [sic] and it is extremely uncertain whether it will ever have to be paid. In fact all accruals in prior years going back as far as the year 1939 are still unpaid to the present time. These unpaid accruals total $129,394.29 as of January 1, 1949.
>
> "The accrual in 1949 as in prior years was based upon a license agreement entered into with General Motors Corporation on January 1, 1937. This agreement provided 10% royalty on headlight testers embodying principles covered in some 10 patents owned by General Motors Corp. For the years 1937 and 1938 royalty payments were made to General Motors Corp. under this agreement. Early in 1938 the taxpayer redesigned its headlight tester in such a way as presumably to eliminate the patented features controlled by General Motors and royalty payments were stopped. Subsequently some correspondence was received from General Motors Corp. calling attention to unpaid royalties and also to liability for infringement. The last letter received was dated December 30, 1940. Since that date no further demands have been made on the taxpayer. This indicates that General Motors Corp. has evidently concluded that royalty payments are no longer collectible under the agreement. . . . This is

especially evidenced by the lapse of time since December 30, 1940.

"Accordingly, the accrual is deemed to be too uncertain, contingent, and remote to represent a true liability. Also the taxpayer does not admit the liability to General Motors Corp. Reference is made to Sections 23 and 43 of the Internal Revenue Code and also to the court decisions, *Dixie Pine Products Co.* v. *Comm.*, 320 U.S. 516 and *Security Flour Mills Co.* v. *Comm.*, 321 U.S. 281." (Plaintiff's Exhibit 42)

Thereafter respondent required petitioner to discontinue the practice of claiming deductions for royalty expense accruals for subsequent years and to amend its returns for the three previous years 1949 through 1951. Petitioner amended its returns for said three years, paid the additional taxes resulting therefrom and discontinued the practice. Nothing was then done or required to be done, however, regarding the accumulated royalty expense accruals for the years 1939 through 1948, which actually aggregated $129,889.66. Irrespective of the contents of the foregoing letter of August 5, 1952, the record demonstrates that it is conceded by all parties hereto that the accruals for the years 1939 through 1948 were proper and legitimate when made.

### C. The Legal Termination of All Petitioner's Patent Royalty Liability in 1959 through Expiration of Local Limitations.

In 1962, petitioner determined that all its liability to General Motors for the unpaid royalty accruals for the years 1939 through 1948 had become barred by no later than 1959 through expiration of the Illinois Statute of Limitations at Ill. Rev. Stat. C. 83 § 17, which was ap-

plicable to the licensing agreement.[1] It thereupon, for the calendar year 1962, made an adjusting book entry transferring the amount of these unpaid accruals, i.e., $129,889.66, to its surplus account. It reported this transaction to the Commission, but did not include the amount involved as taxable income for said year.

**D. Deficiency Assessment for 1962.**

In 1964, the Commissioner under the "so-called tax benefit rule" assessed a deficiency tax due from petitioner for the calendar year 1962, in the amount of $67,542.62 plus interest and penalties aggregating $7,031.83. This entire assessment is attributable solely to petitioner's failure to include the amounts involved in the foregoing bookkeeping adjustment in its taxable income for 1962. In 1964, the years 1959 and earlier were closed to the Commissioner under 26 U.S.C. §6501. Petitioner paid the deficiency assessment, interest and penalties and thereafter filed a timely claim for refund which the Commissioner disallowed. Under authority of 28 U.S.C. §1346 (a)(1), petitioner thereafter brought suit against the United States in the District Court for the Southern District of Illinois to recover said amounts, alleging them to have been wrongfully assessed and collected. That Court, after a hearing without a jury, entered judgment for respondent on October 20, 1969. The Court of Appeals affirmed the District Court on July 30, 1970, and thereafter on August 25, 1970 denied a rehearing.

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(1) The final installment of royalties owing for the year 1948 were payable under the licensing agreement in the first quarter of 1949. Hence the ten year statute of limitations expired in 1959 rather than 1958. Until then the liability for royalties was a legally viable one so far as the creditor was concerned notwithstanding the respondent's determination in 1952.

## REASONS FOR GRANTING THE WRIT.

Petitioner was an accrual method taxpayer. At 26 U.S.C. §446 (a) it is provided that "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." The Income Tax Regulations (1954-1960) §1.446-1 (e)(i)(ii) (.... C.F.R. .....; 70 Vol. CCH ¶2763) recite that "Generally, under an accrual method, income is to be included for the taxable year when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." In *Spring City Foundry Co.* v. *Comm'r*, 292 U.S. 182 (1933) this Court held that in the case of an accrual taxpayer, it is the crystallization of the right to receive income, not its prior expectation nor its subsequent receipt that determines the year in which income must be declared for tax purposes.

No claim was made that petitioner's regular accounting methods do not accurately reflect income. Therefore, applying the foregoing principles regarding accrual taxpayers to the context of the tax benefit rule, petitioner believes that its previously deducted but unpaid expense accruals totalling $129,889.66 became recovered as income and taxable to it as such by no later than 1959. In 1952, respondent, apparently believing that local statutes of limitations are not decisive as to when a liability terminates, had decided that petitioner's liability for patent royalties, "considering a history of ten years inaction by General Motors" had ended by 1949. If petitioner's right to restore the previously deducted expense accruals did not crystallize at that time, then certainly that right crystallized by 1959. In that year, all petitioner's liability for

patent royalties—an obligation that had been created under Illinois law—became legally terminated by expiration of the Illinois statute of limitations. Ill. Rev. Stat. C. 83 §17. But notwithstanding the fact that Illinois limitations barred the liability by 1959, and notwithstanding the respondent's earlier determination that petitioner's liability had ended by 1949, the Court of Appeals has now decided in favor of the respondent that for federal tax purposes, petitioner's liability for these accruals did not terminate "as a practical matter" *until 1962.*

Two reasons are given by the Court of Appeals in support of this conclusion that petitioner's liability first terminated "as a practical matter" some three years after it had already legally expired. Both of these two given reasons are conspicuously frivolous, and neither could have been a real reason. These two assigned reasons are:

(a) That "taxpayer . . . [might yet have chosen] . . . for credit purposes or other sound business reasons to acknowledge and pay . . . [the] . . . liability after . . . [1959] limitations . . . [had] . . . run." Obviously that same option to pay was also available to the taxpayer after 1962; it is available yet. If the existence of that option prevented the termination of the liability in 1959 for tax purposes, then for the same reasons, it should also have prevented its "practical termination" in 1962; it should prevent it from terminating even yet. Obviously the existence of that option to pay what is no longer a legal obligation provides no meaningful basis for the conclusion that petitioner's "liability" for the royalties did not terminate "as a practical matter" until 1962. This "reason" could not have been a real reason for the Court's decision.

(b) That although bookkeeping entries do not create income or liabilities or constitute, *per se*, a taxable event, nonetheless the 1962 accounting transfer here did constitute such taxable event, because "with the transfer" the money "for all practical purposes . . . became available for general use" in petitioner's business. Obviously, every book entry transferring funds from a liability account to a surplus account evidences "for all practical purposes" the availability of such amount for general uses. If that consequence makes the book entry a taxable occasion, then every such book entry is, and nothing is left to the principle that bookkeeping entries do not *per se* create income or constitute a taxable occasion. But that principle has been firmly settled by a long line of cases which follow language set out in *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179 (1918). Certainly this thesis that the book entry here evidenced the availability of funds cannot seriously be considered a real reason for the Court's decision.

The clue as to the real reason for the decision of the Court of Appeals is set out in a footnote to its decision, as follows:

> "Since the Commissioner made no assessment against Bear until 1964, the year 1959 was closed to assessment. 26 U.S.C. §6501."

It is for that apparent real reason that the Court of Appeals, erroneously considering itself licensed to do so under the principle set forth in *Tyler* v. *United States*, 281 U.S. 497, 503 (1930) that "Taxation is eminently practical," concluded that petitioner's liability first terminated "as a practical matter" some three years after it had already legally expired in 1959. It thereby condoned

the Commissioner's claim of right, out of practical considerations of administrative convenience in avoiding the bar of 26 U.S.C. §6501, to include within petitioner's income for 1962, sums that under the accrual method of accounting were rightfully attributable to an earlier year, i.e., no later than 1959. This decision requires an exercise of supervisory authority by the Supreme Court because:

1. This decision of the Court of Appeals, not openly, but by erosion of laws which formerly precluded it, grants the Commissioner in effect, an arbitrary discretion to add to a taxpayer's income for a given year items which under the taxpayer's method of accounting rightfully belong to an earlier period where there exists the "practical" considerations that (a) the bar of federal limitations under 26 U.S.C. §650[illegible] might otherwise permit such items to escape taxation, and (b) that administrative convenience is served by relieving the Commissioner of the burden of proving that exceptions under §6501 (c) or (e) are applicable. Unless reversed, this decision of the Court of Appeals will have important consequences in the administration of the revenue acts.

2. The decision of the Court of Appeals is squarely contrary to the holdings in:

(a) *Studebaker-Packard Corp.* v. *United States* (N.D. Ind., 1961) This case, on its facts, is most nearly like the case at bar except that the liability for royalty accruals there became first terminated by litigation rather than a statute of limitations. Like the case at bar the Commissioner had assessed a tax deficiency in a later year when an adjusting book entry was made. The Court held the Commissioner's deficiency assessment illegal.

(b) *Pittsburg Industrial Engineering Co.* v. *Comm'r*, 9 TCM 1132 (CCH Dec. 18,037 (M) (1950)). The Court of Appeals has distinguished this case on the basis that the income there "was *admittedly* realized prior to the 1942 bookkeeping transfer." (Emphasis added) The Court of Appeals erred; whether the income there was realized prior to the 1942 bookkeeping transfer was the ultimate issue to be decided in the *Pittsburg* case. What the Government admitted and did not dispute in the *Pittsburg* case was that certain facts had transpired prior to 1942, but it denied that these previous facts resulted in the realization of income prior to taxpayer's 1942 book entries. The Court held that these prior facts did result in income before 1942, and that the 1942 bookkeeping transfer was not a taxable event. In the case at bar, the Government also admits that certain facts transpired before the 1962 bookkeeping entry, but denies that these prior facts resulted in the realization of income before the 1962 bookkeeping entry.

(c) *Policy Holders Agency, Inc.* v. *Comm'r*, 41 TC 44 (1963) In this case, taxpayer accrued and deducted certain premium refunds due its policyholders but it never paid them. Upon expiration of limitations in 1958, it credited the amounts thereof to its surplus in 1958. The Court held that evidence relating to taxpayer's long and constant experience with these unclaimed premium refunds showed that taxpayer's liability for said amounts had actually ceased prior to 1958, and, therefore, they were not taxable in 1958. It is in this sense that local statutes of limitations may be held not to be controlling; a Court may find from the evidence, as it did in *Policy*

*Holders,* that the liability terminated *earlier.* It is the underlying facts that control, not book entries.

The Court of Appeals in the case at bar distinguished *Policy Holders* on the grounds that "Unlike the taxpayer in *Policy Holders Agency, Inc.,* Bear [i.e., petitioner] apparently had no prior experience of this sort which might indicate a different termination for practical purposes." That "distinction" is sham. At footnote 3 of its decision, the Court of Appeals itself alludes to portions of the record herein which show petitioner's prior experience of ten years inaction by General Motors, with respect to the royalty accruals, and to petitioner's prior experience with the respondent in 1952 when the Internal Revenue Service apparently decided that by 1949, petitioner's liability for royalties had terminated as a practical matter.

The Court of Appeals in the case at bar also states that "All the record shows [in the case at bar] is that Bear decided not to settle with General Motors, hoping that General Motors might sleep on its rights and be barred from recovery by the statute of limitations at some indeterminate time in the future." That this statement is manifestly inaccurate is evidenced by other parts of the decision which acknowledge that the record contains important additional facts. The record also shows that General Motors did in fact sleep on its rights; that for over ten years it did nothing, until finally the Internal Revenue Service, in 1952, determined for such reason that petitioner's liability for royalties had terminated in 1949 as a practical matter; that despite this ruling in 1952 the Commissioner did not then require that royalties accrued for years prior to 1949 be restored to in-

come; that General Motors continued to sleep on its rights thereafter; that petitioner's liability for such royalty accruals during the years 1939 through 1948 finally even became barred legally by expiration of the Illinois statute of limitations in 1959; and that when the Commissioner made his deficiency assessment in 1964, the years 1959 and earlier were barred to him under 26 U.S.C. §6501.

3. The decision of the Court of Appeals in the case at bar is in direct conflict with principles established by the Courts of Appeals for the Second, Third, Fourth, Eighth and Tenth Circuits.

In *Comm'r* v. *Mnookins Estate*, 184 F. 2d 89 (8th Cir., 1950), the Court stated:

> "Sections 41 and 42 of the [1939] Internal Revenue Code 26 U.S.C.A. §§41, 42 [now 26 U.S.C. §§ 441, 446, 451 and 454], and the Treasury Regulation pursuant thereto . . . require that a taxpayer's net income must be computed on the basis of his annual accounting period . . .; that if the method of accounting regularly employed by taxpayer clearly reflects his income, as is conceded here, his income must be computed in accordance therewith. The taxpayer's method of accounting will control the time as of which income must be taken and deductions allowed. The Courts hold that neither income nor deductions may be taken out of the proper accounting period for the benefit of the Government or the taxpayer." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 285, 287, 64 S. Ct. 596, 88 L. Ed. 725; *Ross* v. *Commissioner*, 1 Cir., 169 F. 2d 483, 492, 7 ALR 2d 719. In this case there is no suggestion of fraud on the part of . . . [taxpayer] . . . All the evidence shows is mistake. . . . In the years prior to 1942 [taxpayer's] . . . books were kept on the accrual basis. As so kept they correctly reflected his income

> for those years. The Commissioner having failed to assert the Government's claim for deficiencies for the years prior to 1942, may not circumvent the statute because otherwise the income of . . . [taxpayer] . . . for years prior to 1942 will escape taxation . . . [citation] . . . The discretion which the Commissioner has under section 41 of the Code to make such computations as will clearly reflect income, does not empower him to add to a taxpayer's gross income for a given year an item which rightfully belongs to an earlier year."

The same rule was adopted in *Goodrich* v. *Comm'r*, 243 F. 2d 686, 689 (8th Cir. 1957). It was also adopted by the Courts of Appeals in other circuits in the following cases: *Comm'r* v. *Dwyer*, 203 F. 2d 522 (2nd Cir., 1953); *Comm'r* v. *Schuyler*, 196 F. 2d 85 (2nd Cir., 1952); *Comm'r* v. *Frame*, 195 F. 2d 166 (3rd Cir., 1952); *U. S.* v. *Wilkins*, 385 F. 2d 465, 469 (4th Cir., 1967); *Clinton Mfg. Co.* v. *Comm'r*, 137 F. 2d 290, 293 (4th Cir., 1943); *Beacon Publishing Co.* v. *Comm'r*, 218 F. 2d 697, 702 (10th Cir., 1955) and in *Comm'r* v. *Tyree's Estate*, 215 F. 2d 78 (10th Cir., 1954).

No dispute exists here about the fact that petitioner's regularly employed accounting methods accurately reflected its income within the meaning of these cases.

4. The decision of the Court of Appeals is in conflict with and misinterpretative of principles set forth by this Court:

> (a) In *Spring City Foundry Co.* v. *Comm'r*, 292 U.S. 182 (1933). As noted earlier, this Court therein held that in the case of an accrual method taxpayer, it is the crystallization of the right to receive income, not its prior expectation nor its subsequent receipt that determines the year in which income must be declared for tax purposes.

(b) In *Doyle* v. *Mitchell Bros. Company*, 247 U.S. 179, 187 (1918), This Court therein stated that bookkeeping entries and adjustments do not create income or liabilities but are merely of evidentiary value in establishing the fact and times of their occurrence. This principle of the *Doyle* case has been followed in a long line of decisions including *Policy Holders Agency, Inc.* The record here shows that petitioner's 1962 bookkeeping entry reflected, not a concurrent crystallization of rights, but events which had crystallized in rights by no later than 1959.

(c) In *Tyler* v. *United States*, 281 U.S. 497, 503 (1930), this Court therein stated that "The power of taxation is a fundamental and imperious necessity of all governments, not to be restricted by mere legal fictions. . . . Taxation, as it many times has been said, is eminently practical. . . ."

The Court of Appeals has misinterpreted this principle of practicality, and has applied it, not to sweep away a legal fiction, but to create one. The conclusion that petitioner's liability for royalties did not terminate "as a practical matter" until three years after it had already become legally expired is a pure legal fiction. The Court of Appeals erred in concluding that it was licensed under the principle of this case, and out of the "practical consideration" that because of the bar of 26 U.S.C. §6501, the items involved might otherwise escape taxation to hold that petitioner's liability terminated "as a practical matter" some three years after it was legally barred. The meaning of the principle set out in *Tyler* is evidenced by cases set out herein at paragraph 5.

**5. The cases cited and relied upon by the Court of Appeals are substantially distinguishable and do not support its decision.**

**(a) The cases of *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F. 2d 6 (5th Cir., 1945); *Boston Consol. Gas Co.* v. *Comm'r*, 128 F. 2d 473 (1st Cir., 1942); *Charleston & W.C. Ry. Co.* v. *Burnett*, 50 F. 2d 343 (D.C. Cir., 1931); *Chicago R.I. & Pac. Ry. Co.* v. *Comm'r*, 47 F. 2d 990 (7th Cir., 1931); *Lime Cola Co., et al.* v. *Comm'r*, 22 TC 593 (1954); *Roxy Custom Clothes Corp.* v. *United States*, 171 F. Supp. 851 (Ct. Cl., 1959); and *Fidelity Phila. Trust Co.* v. *Comm'r*, 23 TC 526 (1954), which are cited by the Court of Appeals, are substantially distinguishable and do not support the decision. In all of these cases, the taxpayers, *prior to any legal termination* of their liabilities for previously deducted but unpaid expense items, voluntarily eliminated these items as liabilities on their books. The Courts held in these cases that if the taxpayers thus elected to treat their liabilities as terminated for all practical purposes, then the Commissioner, for purposes of taxation, could also regard the liabilities as having terminated as a practical matter; he is not required to wait until the liability has legally terminated if the taxpayer hasn't. "Taxation . . . is eminently practical." Moreover where a previously deducted but unpaid expense item is added back to income by the taxpayer, before his liability has legally terminated, then in that context, the adjusting book entry evidences *not any previous crystallization of a right* to restore said sums to income, but a concurrent election to treat as expired, a liability that technically is still legally viable. In these cases, the taxable event**

is necessarily concurrent with the time of the transfer, irrespective of the taxpayer's accounting method.

Some of these cited cases do state, and there is no dispute about the fact, that state statutes of limitations are not necessarily controlling as to when a liability has terminated for purposes of federal taxation. But this is only to say that the liability may have terminated by some previous event, either legally, as by settlement or forgiveness, or because of a taxpayer's prior election to regard the debt terminated as a practical matter. These cases do not support the proposition that state statutes of limitation are of no evidentiary value, or that a court is free to regard a legally barred "liability" as being viable until it became terminated as a "practical matter" at some subsequent time.

Only one case, *G.M. Standifer Construction Corp.* v. *Comm'r*, 30 B.T.A. 184 (1934), has ever held that the Commissioner may decide that a liability may be held to have expired for tax purposes at some date subsequent to the time it has legally terminated by limitations. As in the case at bar, the authorities upon which it relied are distinguishable and for the same reasons. Moreover, this case has been superseded by later decisions of the Tax Court set out herein at paragraph 2, viz., the cases of *Pittsburg* and *Policy Holders Agency, Inc.* Nonetheless, the Court of Appeals in the case at bar relied upon the *Standifer* decision.

(b) The record will show that in 1952 the Internal Revenue Service, not petitioner, considering a history of over ten years inaction by General Motors with respect to the accrued but unpaid royalties, deter-

mined that taxpayer's liability for royalties was "too uncertain, contingent and remote to represent a true liability." Respondent determined then that taxpayer's liability had terminated as a practical matter by 1949, and did not exist in 1949. Thus in 1952, as to the three years (i.e. 1949, 1950 and 1951) not then barred under 26 U.S.C. §§275, 276 (1939) (now 26 U.S.C. §6501) respondent required petitioner to amend its returns, and this was done. If the liability terminated as a practical matter in 1949, then surely petitioner's right to restore the accrued expenses for the earlier years of 1939 through 1948 crystallized at the same time, and these funds became taxable in 1949. The mistake made then cannot be corrected now. But if such sums were not taxable in 1949, when respondent previously said the liability had terminated as a "practical matter," they were certainly taxable by 1959 when the legal liability terminated. They were not taxable in 1962. The Commissioner should not be given the arbitrary authority he has assumed here, to regard such items as recovered in any of a multiple of occasions as may suit administrative convenience.

## CONCLUSION.

Petitioner recognizes that the Court's docket is crowded with many cases of urgent social importance. We respectfully submit, however, for the reasons assigned, that this case presents a matter of equally pressing social importance, i.e., the continuing need for the judiciary to restrain efforts by the Internal Revenue Service to expand its discretion to the point where it may lay legiti-

mate claim, out of "practical considerations," to wholly arbitrary powers. Although it may be conceded that "taxation is an imperious necessity of government," that principle must not be conceived as an excuse for separate branches of government to participate together in any commonly conceived governmental purpose, or to erode the overriding principle that the judiciary has a primary responsibility for restraining governmental excesses upon the rights of private citizens. That practice, more than any other, is destructive of and exemplifies a basis for growing lack of public confidence in government. For stated reasons that are conspicuously frivolous, and in avoidance of underlying irrelevant motives, the lower federal courts, whether because of crowded dockets or misplaced reliance on the so-called expertise of a federal governmental agency, have condoned error, not in a suit between private citizens, but in favor of the government and against a private citizen. An exercise of supervisory authority by the Supreme Court is required and respectfully requested.

Respectfully submitted,

BEAR MANUFACTURING COMPANY,
*Petitioner*

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# APPENDIX A

In The
UNITED STATES COURT OF APPEALS
For the Seventh Circuit

SEPTEMBER TERM, 1969 — APRIL SESSION, 1970

No. 18221
BEAR MANUFACTURING COMPANY,
*Plaintiff-Appellant,*

v.

UNITED STATES OF AMERICA,
*Defendant-Appellee.*

Appeal from the United States District Court for the Southern District of Illinois, Southern Division.

July 30, 1970

Before SWYGERT, *Chief Judge*, MURRAH, *Senior Circuit Judge*,[1] and CAMPBELL, *Senior District Judge*.

MURRAH, *Senior Circuit Judge*. In this appeal from the trial court's adverse determination of Bear's income tax refund claim, we must apply to unique facts the general rule that items deducted from gross income in one year are taxable income in the year of their recovery. *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296 (1946); *Alice Phelan Sullivan Corp.* v. *Comm'r*, 381 F. 2d 399 (Ct. Cl. 1967); *Estate of William H. Block*, 39 B.T.A. 338, aff'd sub nom. *Union Trust Co.* v. *Comm'r*, 111 F. 2d

[1] Senior Circuit Judge Murrah of the United States Court of Appeals for the Tenth Circuit is sitting by designation.

60 (7th Cir. 1940).[2] The parties are agreed that certain accrued royalty expenses, deducted from income in prior years but never paid, must be returned to Bear's income in some taxable year. The question is whether the Commissioner correctly determined that the money was recovered and realized as income in 1962 when Bear transferred the money to surplus on its books.

In 1937 Bear Manufacturing Company, an accrual basis taxpayer engaged in the manufacture of automotive testing equipment, agreed to pay royalties to General Motors for the use of certain patents in the manufacture of its products. A dispute as to the amount of royalties due General Motors arose in 1938 and Bear refused to make further payments. But in order to protect itself from what it then regarded as certain liability, Bear set off an accrued royalty expense against its income for the years 1939 through 1948 which aggregated $129,889.66.

In 1949 the Commissioner, determining that the royalty liability was "too uncertain, contingent and remote to represent a true liability," disallowed a further deduction but made no attempt to include the amount of the previous deductions in Bear's income.[3] None of the money was ever paid to General Motors and until 1963 Bear

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[2] In our case all of the deductions resulted in tax benefit and no problem is raised under § 111 of the Internal Revenue Code of 1954.

[3] The Commissioner's determination was made in a 1952 examination of Bear's 1949 return. Bear eliminated the deductions for the years 1949 through 1951 and paid a deficiency assessment for each year. The disallowance of royalty expense deductions after 1948 was based on a determination that after ten years of inaction by General Motors no new liability arose from Bear's 1949 manufacture of products allegedly incorporating General Motors patents. There is no indication that, as Bear contends, the Commissioner intended to reverse his allowance of the earlier deductions as legitimate. The Commissioner has consistently treated the deductions in question as proper in the year taken and no question is now raised in that regard. Cf. *Northwestern States Portland Cement Co.* v. *Huston*, 126 F. 2d 196 (8th Cir. 1942); *Studebaker Packard Corp.* v. *United States*, 8 Am. Fed. Tax R. 2d 5058 (N.D. Ind. 1961).

carried the $129,889.66 on its books and financial statements as a liability. In that year, on the advice of its accountant, Bear transferred the money to surplus as of the end of 1962, but did not report it as income for either 1962 or 1963.

In 1964 the Commissioner determined that the allocation to surplus was income in 1962 and assessed additional taxes of $67,542.62. Bear paid the assessment and, after the Commissioner disallowed its claim for refund, brought this action in the District Court under 28 U.S.C. § 1346 (a)(1). The argument was that the income was realized sometime prior to 1962 and certainly no later than 1959. This argument was based upon the postulate that a new cause of action accrued to General Motors each year from 1937 through 1948; that the local statute of limitations, Ill. Rev. Stat., C. 83, § 17, barred the last cause of action no later than 1959;[4] and that in that year the right to the money as income was established and income was, therefore, realized under principles of accrual accounting.[5]

Rejecting this basic argument, the District Court concluded that Bear's 1962 bookkeeping entry marked the point at which the liability terminated as a practical matter and the money became available for general use in Bear's business. In arriving at this conclusion, the court agreed with the Commissioner that the local statute of limitations was not controlling on these facts.

We think the District Court's decision is supported by the case law and by common sense. The parties agree

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[4] The parties apparently agree that Illinois law, including its statute of limitations, applied to questions of enforceability of the Bear-General Motors agreement. *William J. Lemp Brewing Co.* v. *Ems Brewing Co.*, 164 F. 2d 290 (7th Cir. 1948); *Ryan* v. *Napier*, 252 F. Supp. 730 (N.D Ill. 1966).

[5] Since the Commissioner made no assessment against Bear until 1964, the year 1959 is closed to assessment by the Commissioner. 26 U.S.C. § 6501. And see 26 U.S.C. §§ 1311(b)(1), (b)(2)(A), 1312 (3)(B); 2 J. Mertens, Federal Income Taxation § 14.08 (1969).

that a previously deducted liability expense is "recovered" and income realized when the liability terminates as a practical matter. The taxpayer's disregard of the liability and use of the money for his own purposes is the factor usually relied on as indicative of such a termination. *Wichita Coca Cola Bottling Co.* v. *United States,* 152 F. 2d 6 (5th Cir. 1945); *Boston Consol. Gas Co.* v. *Comm'r,* 128 F. 2d 473 (1st Cir. 1942); *Charleston & W.C. Ry. Co.* v. *Burnett,* 50 F. 2d 343 (D.C. Cir. 1931); *Chicago, R.I. & Pac. Ry. Co.* v. *Comm'r,* 47 F. 2d 990 (7th Cir. 1931); Lime Cola Co., 22 TC 593 (1954). This is so even where the taxpayer's exercise of control over the money precedes the running of the statute of limitations governing recovery of the liability. *Roxy Custom Clothes Corp.* v. *United States,* 171 F. Supp. 851 (Ct. Cl. 1959); Fidelity Phila. Trust Co., 23 T.C. 527 (1954).

Bear agrees with this case law, but argues that the accrual accounting system requires a different result where the statute of limitations runs before the accrual basis taxpayer uses the money for his own purposes. We disagree. The expiration of the period in which actions may be brought to recover the unpaid expenses from the taxpayer does not necessarily mark the practical termination of that liability. G. M. Standifer Constr. Co., 30 B.T.A. 184 (1934). A taxpayer may choose, for credit purposes or other sound business reasons, to acknowledge and pay a liability after the statute of limitations has run. The point at which the liability first terminated must be determined on the particular facts of each case and, as the District Court properly concluded, the local statute of limitations is not necessarily controlling on that question. *Roxy Custom Clothes Corp.* v. *United States, supra;* Policy Holders Agency, Inc., 41 T.C. 44 (1963); *Fidelity Phila. Trust Co., supra; G. M. Standifer Constr. Co., supra.*

Applying these principles to the present case, we agree with the District Court that the Commissioner correctly

determined that the liability did not terminate as a practical matter until 1962. Unlike the taxpayer in *Policy Holders Agency, Inc., supra,* Bear apparently had no prior experience with liabilities of this sort which might indicate a different termination for practical purposes. And, despite Bear's contentions to the contrary, there is no indication that it believed the local statute of limitations had terminated its liability and freed the money prior to 1962. All the record shows is that Bear decided not to settle with General Motors, hoping that General Motors might sleep on its rights and be barred from recovery by the statute of limitations at some indeterminate time in the future.

Although bookkeeping entries are not necessarily determinative of income tax liability, *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179, 187 (1918); *Northwestern States Portland Cement Co.* v. *Huston, supra; Comm'r* v. *North Jersey Title Ins. Co.*, 79 F. 2d 442 (3d Cir. 1935); *Policy Holders Agency, Inc., supra,* the 1962 transfer to surplus in this case represented a taxable event. Cf. Pittsburgh Industrial Engineering Co., 9 CCH Tax Ct. Mem. 1132 (1950) (where the income was admittedly realized prior to the 1942 bookkeeping transfer). With that transfer the liability terminated for all practical purposes and the money became available for general use in Bear's business. Bear has clearly failed to meet its burden of proving the Commissioner's determination erroneous and we affirm the District Court's judgment. See *North American Coal Corp.* v. *Comm'r*, 32 B.T.A. 535 (1935), aff'd 97 F. 2d 325 (6th Cir. 1938).

A true Copy:

Teste:

.....

*Clerk of the United States Court of Appeals for the Seventh Circuit.*

# APPENDIX B

IN THE UNITED STATES DISTRICT COURT
For The Southern District of Illinois
Southern Division

BEAR MANUFACTURING COMPANY,
*Plaintiff*,
v.
UNITED STATES OF AMERICA,
*Defendant*.

Civil Action
No. 3918

## FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Court, after trial upon the facts of this action, without a jury, the submission of briefs and oral argument before the Court by the parties, pursuant to Rule 52 of the Federal Rules of Civil Procedure, makes and enters the following:

### *Findings Of Fact*

1. The plaintiff at all times material to this action was a corporation organized and existing under the laws of the State of Delaware with offices and plants in the City of Rock Island, Illinois. (Pltf. Ex. 41, par. 1.)

2. On January 1, 1937, the plaintiff entered into a contract with General Motors whereby the plaintiff agreed to pay a royalty to General Motors of 10% of the sale price of certain devices which the plaintiff intended to make and sell using the General Motors patents set out in the agreement. (Pltf. Ex. 41, par. 6.)

3. In 1937 the plaintiff commenced the manufacturing and sale of headlight testers using the patents set out in the agreement of January 1, 1937. (Pltf. Ex. 41, par. 7.)

4. During the years 1939 through 1948, the plaintiff accrued total royalties of $129,889.66, due General Motors under the license agreement and deducted the amount on its tax returns for those years, although no payments were actually made to General Motors on account of the liability. (Pltf. Ex. 41 (par. 10, 14), Tr. 11-12.)

5. During each of the years 1939 through and including 1948, the plaintiff had taxable income which was in excess of the amounts which were deducted for the accrued but unpaid license royalties owed to General Motors arising out of the license agreement of January 1, 1937. (Pltf. Ex. 41, par. 13.)

6. The amount of accrued royalties deducted by the plaintiff during the period 1939 through 1948, $129,889.66, was carried on the plaintiff's books of account and certified public statements until 1962, as an accrued liability. (Pltf. Ex. 41 (par. 14), Tr. 71-72.)

7. On or about December 31, 1962, the plaintiff adjusted its books to eliminate the $129,889.66, accrued liability and increase its retained earnings, or surplus account. (Pltf. Ex. 41 (par. 15), Tr. 67-68).

8. On its federal income tax return for the year 1962, the plaintiff did not include as income the amount of $129,889.66, representing the amounts previously deducted as a royalty expense. (Pltf. Ex. 41, par. 16.)

9. On or about December 18, 1964, the District Director assessed additional income taxes for the year 1962 against the plaintiff in the amount of $67,542.62,

and that on or about December 22, 1964, plaintiff paid such deficiency together with statutory interest thereon in the amount of $7,031.83. (Pltf. Ex. 41, par. 3.)

10. The deficiency assessed by the District Director was due to the failure of the plaintiff to include the amount added by it to surplus, $129,889.66, in its income for 1962. (Pltf. Ex. 41, par. 17.)

11. On or about May 8, 1965, the plaintiff filed a claim for refund of income taxes, paid by it for the calendar year 1962, in the amount of $67,542.62, which was disallowed by the District Director. (Pltf. Ex. 41, par. 4.)

12. This action was timely brought against the United States of America and this Court has jurisdiction of this action under 28 U.S.C. Section 1346(a)(1). (Pltf. Ex. 41, par. 5.)

CONCLUSIONS OF LAW

1. The taxpayer has the burden of proving that its taxes were in fact overpaid. *Compton* v. *United States*, 334 F. 2d 212 (C.A. 4th, 1964).

2. Not only has the taxpayer failed to meet its burden, but further, the trial record shows the District Director's determination to be clearly correct.

3. When an accrued expense has been recorded and deducted and later not paid, the tax benefit must be restored to income. *Estate of Block* v. *Commissioner*, 39 B.T.A. 338, affirmed *sub nom. Union Trust Co.* v. *Commissioner*, 111 F. 2d 60 (C.A. 7th), certiorari denied, 311 U.S. 658; *Chicago, R. I. & P. Ry. Co.* v. *Commisisoner*, 47 F. 2d 990, 992 (C.A. 7th); *Pierce Corp.* v. *Commissioner*, 326 F. 2d 67 (C.A. 8th) and cases cited therein.

4. It is well settled that the District Director may include unpaid, but otherwise legitimate accruals in income in the year in which they are reversed and added to surplus. *Chicago, R. I. & P. Ry. Co.*, 47 F. 2d 990, 992 (C.A. 7th); *North American Coal Corp.* v. *Commissioner*, 32 B.T.A. 535, 542, affirmed 97 F. 2d 325 (C.A. 6th); *Boston Consol. Gas Co.* v. *Commissioner*, 128 F. 2d 472 (C.A. 1st); *Roxy Custom Clothes Corp.* v. *United States*, 171 F. Supp. 851 (Ct. Cl.); *Vanguard Recording Society, Inc.* v. *Commissioner*, 51 T.C. 819 (pending on appeal by taxpayer to C.A. 2d).

5. The taxpayer contends that book entries alone do not determine income. This statement is true, as far as it goes. Bookkeeping entries are not, of themselves, definitive. But book entries are significant in that they are presumed to represent specific items of income and liability for a taxpayer utilizing the accrual method of accounting. *Rouss* v. *Bowers*, 30 F. 2d 628 (C.A. 2d).

6. Bookkeeping entries do not create income but they can mark the year when a previously deducted item is restored to income by the taxpayer. *Vanguard Recording Society, Inc., supra.*

7. The taxpayer's reduction in its liabilities and consequent increase in its net worth was a financial act which created income in the year in which the adjustment was made. *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F. 2d 6 (C.A. 5th), certiorari denied 327 U.S. 806.

8. The act of the taxpayer strengthened its balance sheet and made the amount in question available for the general uses of the business. Under such circumstances, such amount is properly included in the taxpayer's income. *Roxy Custom Clothes Corp., supra.*

9. The book entries in the instant case are significant because they mark the point in time when it was reasonable to conclude as a practical matter that the accrued royalties would not, in fact, be paid over to General Motors.

10. Furthermore, they represent an assertion of dominion over such royalties by the taxpayer which, by the transfer to earned surplus, undertook to deal with the amount as its own funds. *Chicago, R. I. & P. Ry., supra.*

11. The taxpayer claims that the statute of limitations had run against its creditor, sometime before 1962. However, a local statute of limitation is not decisive as to what constitutes taxable income. *Policy Holders Agency, Inc.* v. *Commissioner*, 41 T.C. 44.

12. The statute is a factor which may be considered by the District Director but it is not controlling. *North American Coal Corp., supra; Roxy Custom Clothes Corp., supra; G. M. Standifer Construction Corp.* v. *Commissioner*, 30 B.T.A. 184, 186.

Judgment for the United States.

/s/ Omer Poos
United States District Judge

In The

UNITED STATES DISTRICT COURT

For the
Southern District Of Illinois
Southern Division

| | |
|---|---|
| Bear Manufacturing Company, *Plaintiff* vs. United States of America, *Defendant* | Civil Action File No. 3918 |

JUDGMENT

This action came on for trial (before the Court, Honorable Omer Poos, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered,

It is Ordered and Adjudged that the Plaintiff take nothing, that the action be dismissed on the merits, and that the Defendant, United States of America recover of the Plaintiff, Bear Manufacturing Company its costs of action as provided by law.

Dated at Springfield, Illinois, this 20th day of October, 1969.

/s/ William J. Littell
Clerk of Court

# APPENDIX C

IN THE

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Hon. LUTHER M. SWYGERT, Chief Judge
Hon. ALFRED P. MURRAH, Sr. Cir. Judge, Ret.
Hon. WILLIAM J. CAMPBELL, Sr. Dist. Judge

BEAR MANUFACTURING COMPANY,
*Plaintiff-Appellant,*

No. 18221 vs.

UNITED STATES OF AMERICA,
*Defendant-Appellee.*

Appeal from the United States District Court for the Southern District of Illinois, Southern Division.

**It Is Ordered by the Court that the petition for rehearing filed in the above-entitled case be, and the same is hereby denied.**

# APPENDIX D

## STATUTES AND REGULATIONS INVOLVED

a) At 68 A Stat. 33, 26 U.S.C. §111 (1954) (formerly 53 Stat. 9, 26 U.S.C. §22 (b) (12) (1939)) it is provided in pertinent parts:

"(a) General rule.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, or amount.

"(b) Definitions.—For purposes of subsection (a)—

(1) Bad debt.—The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) Delinquency amount.—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) Recovery exclusion.—The term "recovery exclusion" with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such

bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

"(e) Special rules for accumulated earnings tax and for personal holding company tax. . . ."

b) The application of this foregoing 1954 statutory section has been explained by Income Tax Regulation § 1.111-1 (a) ..... C.F.R. ..... ('70 Vol. 1, CCH ¶1127) which provides in pertinent part:

"Recovery of certain items previously deducted or credited—(a) General. Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the 'recovery exclusion' with respect to such items. *The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years,* including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term "recovery exclusion" as used in this section means an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which,

when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E of chapter 2 of the Internal Revenue Code of 1939. [Proposed 6/26/56. Adopted 12/28/56 by TD. 6220] (Emphasis added.)

c) The provision of the 1954 code which provide that a taxpayer's regular accounting methods shall control the time when income was received are at 68A Stat. 148, 26 U.S.C. §§ 441; 68A Stat. 151, 26 U.S.C. 446; and 68A Stat. 152, 26 U.S.C. 451 (formerly 53 Stat. 24, 26 U.S.C. §§ 41, 42 (1939))

"§441. Period for computation of taxable income

"(a) Computation of taxable income.—Taxable income shall be computed on the basis of the taxpayer's taxable year.

"(b) Taxable year.—For purposes of this subtitle, the term 'taxable year' means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

"(c) Annual accounting period.—For purposes of this subtitle, the term 'annual acconuting period' means the annual period on the basis of which the taxpayer regularly computes his income in keeping his books.

"(d) Calendar year.—For purposes of this subtitle the term 'calendar year' means a period of 12 months ending on December 31.

"(e) Fiscal year.—For purposes of this subtitle, the term 'fiscal year' means a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

"(f) Election of year consisting of 52-53 weeks.

. . . ."

"§446. General rule for methods of accounting.

"(a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"(c) Permissible methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

"(d) Taxpayer engaged in more than one business. . . ."

"(e) Requirement respecting change of accounting method. . . ."

"§451. General rule for taxable year of inclusion

"(a) General rule.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

"(b) Special rule in case of death. . . ."

"(c) Special rule for employee tips. . . ."

d) Income tax Regulation § 1.466-1 (c) (i) (ii), ..... C.F.R. ....., ('70 Vol. 3, CCH ¶2763) provides as follows:

"(ii) Accrual method. Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which in-

direct costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books."

e) The Illinois statute of limitations for the years 1947 through 1959 may be found at Ill. Rev. Stat. C. 83 § 17 (1947) (1949) (1951) (1953) (1955) (1957) and (1959), and provided in all of these years, in pertinent parts, as follows:

"Actions on . . . written contracts, or other evidences of indebtedness in writing shall be commenced within ten years next after the cause of action accrued; but if any payment or new promise to pay shall have been made, in writing, on any . . . contract . . . within or after the said period of ten years, then an action may be commenced thereon at any time within ten years after the time of such payment of promise to pay."

f) The 1954 federal statute of limitations on assessment and collection of tax is found at 68A Stat. 803, 26 U.S.C. § 6501 (formerly 53 Stat. 86, 87 as amended, 26 U.S.C. §§ 275, 276 (1939)). It provides

"(a) General rule.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

"(b) Time return deemed filed.

"(c) Exceptions.

"(1) False return.—In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed or a proceeding in court for collection of such tax may be begun without assessment, at any time.

"(2) Willful attempt to evade tax.—In case of a willful attempt in any manner to defeat or evade tax imposed by this title (other than tax imposed by subtitle A or B), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

"(3) No return.—In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

"(4) Extension by agreement.—Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary or his delegate and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

"(5) Tax resulting from changes in certain income tax or estate tax credits.

For special rules applicable in cases where the adjustment of certain taxes allowed as a credit against income taxes or estate taxes results in additional tax, see section 905 (c) (relating to the foreign tax credit for income tax purposes) and section 2016 (relating

to taxes of foreign countries, States, etc., claimed as credit against estate taxes).

"(6) Tax resulting from certain distribution or from termination as life insurance company. . . .

"(d) Request for prompt assessment. . . .

"(e) Substantial omission of items. Except as otherwise provided in subsection (c)—

"(1) Income taxes.—In the case of any tax imposed by subtitle A—

(A) General rule.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—. . . .

"(f) Personal holding company tax. . . .

"(g) Certain income tax returns of corporations. . . .

"(h) Net operating loss carrybacks. . . .

"(i) Foreign tax carrybacks. . . .

"(j) Investment credit carrybacks. . . .

"(k) Reductions of policyholders surplus account of life insurance companies. . . .

"(l) Joint income return after separate return. . . .

"(m) Tentative carryback adjustment assessment period. . . ."

# In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 889

BEAR MANUFACTURING COMPANY, PETITIONER

*v.*

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE UNITED STATES IN OPPOSITION

### OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. 6a–11a) are not reported. The opinion of the court of appeals (Pet. App. 1a–5a) is not yet reported.

### JURISDICTION

The judgment of the court of appeals was entered on July 30, 1970 (Pet. App 1a). A petition for rehearing was denied on August 25, 1970 (Pet. App. 12a). The petition for a writ of certiorari was filed on October 22, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).



409-891—70

## QUESTION PRESENTED

Whether the taxpayer, filing its corporate income tax returns on the accrual basis, realized taxable income in 1952 as a result of a bookkeeping transfer from a liability account to earned surplus of an amount representing patent royalty expenses accrued and deducted from taxable income in prior years but never actually paid to the patent licensor.

## STATUTES AND REGULATIONS INVOLVED

Pertinent provisions of Section 446 of the Internal Revenue Code and of Section 1.446–1(c)(ii) of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix to the petition (Pet. App. 16a–18a).

## STATEMENT

Petitioner is a corporation engaged in the manufacture and sale of automotive testing equipment. In 1937, it entered into a contract with General Motors Corporation whereby it agreed to pay to General Motors a royalty for using certain patents for headlight testers which petitioner intended to manufacture and sell. Petitioner commenced manufacturing the headlight testers in 1937 and paid some royalties, but a dispute arose in 1938 and petitioner refused to make farther payments. From 1939 through 1948, petitioner nevertheless annually accrued on its books and deducted on its corporate income tax returns the unpaid royalty liabilities, which by 1948 totalled $129,889.66. Throughout this period, petitioner's taxable income

was in excess of the amounts so deducted, and it thus gained a tax benefit from the deductions. (Pet. App. 2a, 6a–7a.)

Petitioner continued to accrue and deduct the royalty liabilities for the years 1949 through 1952. In 1953 the Internal Revenue Service disallowed the deductions for those years on the ground that the expenses were contingent and uncertain. No questions were raised as to the propriety of the deductions taken for years prior to 1949. (Pet. App. 2a.)

Petitioner retained the 1939–1948 accrued royalty liabilities on its books of account and certified financial statements until 1962. As of December 31, 1962, petitioner adjusted its books, eliminating the liability and increasing its retained earnings (earned surplus) by $129,889.66. Since that amount previously had been deducted from income but never paid, the Internal Revenue Service determined that it represented income for the taxable year 1962 and assessed a tax deficiency of $67,542.62. Petitioner paid the deficiency and commenced this suit for refund in the district court, which upheld the assessment. (Pet. App. 3a, 7a–10a.)

On appeal, the Seventh Circuit affirmed, holding that the bookkeeping transfer in 1962 marked the termination of the liability. It rejected petitioner's contention that the taxable event occurred in an earlier year, when the local statute of limitations had allegedly barred a claim by General Motors. (Pet. App. 3a–5a.)

## ARGUMENT

The decision below turns essentially on the facts of this case and is correct. There is no conflict of decisions or any other reason for further review.

1. It is generally acknowledged that the return or recovery of property once the subject of an income tax deduction must be treated as taxable income in the year of its return or recovery, unless the initial deduction did not result in a tax saving. *Rothensies* v. *Electric Battery Co.*, 329 U.S. 296; *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399 (Ct. Cl.). Thus, an accrual basis taxpayer who properly deducts an expense which subsequently is not paid, realizes income in the year the liability terminates—that is, the year in which *all* events have occurred which are necessary to fix the right to receive the income and make it possible to compute accurately the amount actually realized. Treasury Regulations on Income Tax (1954 Code), Section 1.446–1(c)(ii).

Petitioner does not dispute these "tax benefit" principles and concedes that they are applicable to this case (Pet. 4). Nor does petitioner deny that it received a tax benefit as a result of deducting, but never paying, patent royalties to General Motors (Pet. 6). However, petitioner contends that, in applying the tax benefit principles to the facts of this case, the lower courts erred in concluding that income was realized in 1962, the year the expense was transferred from its liability account to earned surplus. It contends that the income was actually realized no later than 1959, when the Illinois statute of limitations allegedly barred

legal action by General Motors to enforce the patent royalty agreement. The court of appeals properly rejected this argument, stating (Pet. App. 4a) that "[t]he expiration of the period in which actions may be brought to recover the unpaid expenses from the taxpayer does not necessarily mark the practical termination of that liability."

None of the decisions cited by petitioner support its argument that the running of a local statute of limitations conclusively fixes the point when an accrual basis taxpayer must restore an accrued but unpaid liability to taxable income. Indeed, this factor is seldom controlling, whether it occurs prior or subsequent to an objective manifestation by the taxpayer that the liability will not be paid. *North American Coal Corp.* v. *Commissioner*, 32 B.T.A. 535, affirmed, 97 F. 2d 325 (C.A. 6); *G.M. Standifer Construction Corp.* v. *Commissioner*, 30 B.T.A. 184; *Policy Holders Agency, Inc.* v. *Commissioner*, 41 T.C. 44. While it may affect a creditor's remedy in a court of law, it does not extinguish the debt. A taxpayer may retain a liability on its books of account after the statute has expired for any number of practical business considerations.

The governing rule, which was followed by the court below, requires consideration of all of the facts and circumstances in determining the point when a liability has terminated. Elimination of the liability on the taxpayer's books of account, if (as was the case here) it clearly manifests an intention never to pay the debt and to use the previously earmarked funds for general business purposes, is often accepted as persuasive

evidence that a liability has terminated in the year of such bookkeeping adjustment. *Chicago R.I. & P. Ry. Co.* v. *Commissioner*, 47 F. 2d 330 (C.A. 7); *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F. 2d 6 (C.A. 5).

2. Petitioner's reliance (Pet. 13–14) on *Studebaker-Packard Corp.* v. *United States*, 61–2 U.S.T.C., par. 9331 (N.D. Ind.), and *Pittsburgh Industrial Engineering Co.* v. *Commissioner*, 9 T.C.M. 1132, is misplaced. Neither decision set forth any legal standard for determining when an accrued, but unpaid, liability terminates. Moreover, in both cases the taxpayer had taken an improper deduction in a prior taxable year, while here the deductions for the years 1939 through 1948 were admittedly proper when taken. *Policy Holders Agency, Inc.* v. *Commissioner*, *supra*, also cited by petitioner (Pet. 14–16), does not support its contention. The Tax Court explicitly held in that case (41 T.C. at 49) that "[s]tate statutes of limitations, while of evidentiary value, are not determinative of the factual question of when income is realized." At all events, any conflict between the decision below and the district court and Tax Court cases upon which petitioner relies does not warrant review by this Court.

Contrary to petitioner's assertion (Pet. 16–17), there is no conflict with *Commissioner* v. *Mnookin's Estate*, 184 F. 2d 89 (C.A. 8), and cases following it. Those cases, which involve facts wholly different than

those here, state the general principle that the Commissioner may not tax in one year income that rightfully belongs to an earlier taxable year. The courts below applied that principle in this case. They determined, after considering all the facts and circumstances, that petitioner's liability to General Motors was terminated as a practical matter in 1962, with the result that petitioner realized income in 1962. The record amply supports that determination.

Finally, the decision of the court of appeals is in harmony with the general principles of accrual method accounting enunciated by this Court in *Spring City Co.* v. *Commissioner*, 292 U.S. 182. There, the Court held that a taxable event occurs for an accrual basis taxpayer upon the crystallization of the right to receive income, and not upon a prior expectation or subsequent receipt. But there is no "crystallization" until all the events have occurred necessary to fix the right to receive income which can be accurately calculated. In the instant case, the crucial taxable event did not occur until petitioner manifested its intent not to pay the liability and asserted dominion and control over the corresponding sum for its own corporate purposes. Even though petitioner clearly hoped that General Motors would never assert a claim for the unpaid royalties, it did not actually assert control over the funds until it made the bookkeeping transfer in 1962. It follows that income was not realized until 1962.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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